

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-7060

To be argued by

DANIEL A. POLLACK

United States Court of Appeals
FOR THE SECOND CIRCUIT

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

—against—

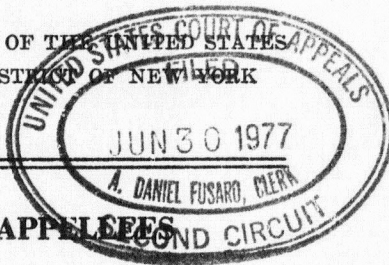
HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F.
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HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MON-
RONEY, CHARLES F. PHILLIPS, JEPHTHA H. WADE, ANCHOR
CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

ON APPEAL FROM ORDERS AND JUDGMENT OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANTS-APPELLEES

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BRIEF OF DEFENDANTS-APPELLEES

Issues for Review

1. Did the directors have the power to exercise their business judgment in these circumstances?

The District Court correctly held that the directors had the power to exercise their business judgment.

2. Were the directors who acted for the Board disinterested and independent?

The District Court correctly held that the directors were disinterested and independent.

Statement of the Case

The plaintiffs, two minority stockholders of Fundamental Investors, Inc. ("Fundamental") ask this Court to nullify a valid and legal exercise of business judgment by directors who had no personal interest in the matter at issue and who made a detailed and extensive study of the entire matter, with the aid of a distinguished and independent special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York. The business judgment which the plaintiffs challenge was a decision by the directors to terminate a derivative litigation. If directors cannot exercise their business judgment in these circumstances, there is little, if anything, left to the rule that it is the directors who have the responsibility and the power to direct the affairs of a corporation.

Fundamental, on the basis of the unanimous vote of disinterested directors constituting a quorum of the Board of Directors, moved to dismiss this action. The District Court (Werker, J.) held that the directors had the power to terminate this litigation in the exercise of their business judgment, but granted the plaintiffs leave to conduct discovery on the issue of whether the directors were disinterested and independent. (404 F. Supp. 1172 (S.D.N.Y. 1975)). Thereafter, the plaintiffs conducted extensive discovery on that issue (including six depositions exceeding 1,000 pages of testimony and two major document productions). At the conclusion of the discovery, Fundamental, joined by all other defendants, renewed its motion to dismiss. The District Court (Werker, J.) held that the directors were disinterested and independent, and, accordingly, dismissed the action (426 F. Supp. 844 (S.D.N.Y. 1977)). The plaintiffs now appeal from these two determinations of the District Court.

Statement of the Facts

Fundamental is an open-end investment company (commonly known as a "mutual fund") registered under the Investment Company Act of 1940 (35 A). Anchor Corporation ("Anchor") is the investment adviser to Fundamental (36 A).

A chronology of the undisputed facts pertinent to this appeal follows:

On November 26, 1969, Fundamental, which had a portfolio at that time worth approximately \$1 billion, purchased from Goldman, Sachs & Co., a commercial paper dealer, \$20 million of the 270-day notes of Penn Central Transportation Company as a short-term investment of unemployed cash (36 A).

On June 21, 1970, Penn Central Transportation Company filed a Petition for Reorganization under the federal bankruptcy laws, and the notes purchased by Fundamental (and many others*) were not paid at maturity. Penn Central Transportation Company is still in the process of being reorganized under the jurisdiction of Hon. John R. Fullam, United States District Judge for the Eastern District of Pennsylvania (36 A).

On November 4, 1970, Fundamental initiated an action, with three other plaintiffs (Welch Foods Inc., C. R. Anthony Company and Younker Brothers) in the United States District Court for the Southern District of New

* Other holders of the Penn Central notes not paid at maturity included numerous major corporations, universities, insurance companies and charitable organizations such as American Express Company, Getty Oil Company, W. R. Grace & Company, University of Southern California, University of Kentucky, College Life Insurance Company of Indiana, the United Conference of Catholic Bishops and the Society for the Ruptured and Crippled. (119 A-120 A).

York, against Goldman, Sachs & Co. ("the *Welch* action") for rescission of their purchases of the notes of Penn Central Transportation Company (36 A).

On February 5, 1973, nearly four years after the purchase of the Penn Central Transportation Company commercial paper by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the *Lasker* action") allegedly on behalf of Fundamental (2 A). The Complaint charged Anchor, the investment adviser to Fundamental, and all of the directors of Fundamental at the time of the purchase (*i.e.* 1969), with violations of statutory and common law duties in connection with the purchase and retention of the Penn Central Transportation Company Commercial paper (6 A-21 A).

On July 30, 1973, on motion of all defendants, and prior to joinder of issue, District Judge Murray I. Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental in the *Welch* action (36 A-37 A).

On July 9, 1974, on the eve of trial of the *Welch* action, the claims of Fundamental against Goldman, Sachs & Co. were settled as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental \$5.25 million in cash and assigned to Fundamental a 73.75 per cent interest in the proceeds of the \$20 million of notes in the reorganization proceedings (37 A).

On July 24, 1974, at their next regular meeting after the settlement of Fundamental's action against Goldman, Sachs & Co., the Board of Directors of Fundamental reviewed the status of the *Lasker* action (39 A).

The Board of Directors determined that the five directors who (a) were not affiliated in any way with Anchor, and (b) were not directors at the time of the events complained of in the *Lasker* action, and (c) were not defendants in the

Lasker action, would, acting as a quorum pursuant to the by-laws,* constitute the Board of Directors to decide what position Fundamental should take regarding the *Lasker* action. The other directors would take no part in the decision (39 A-40 A).

Each of the five disinterested directors constituting the disinterested quorum had a distinguished career in his or her chosen field and brought to the matter at hand the intellect, experience and judgment of high-level executives in business and government. The five disinterested directors were (40 A):

Leon T. Kendall—a professional economist and the President of Mortgage Guaranty Insurance Corporation of Milwaukee, Wisconsin, the largest mortgage insurance company in the country. He had been a member of the faculty of the School of Business, Indiana University, an economist for the Federal Reserve Bank, Atlanta, an economist for the New York Stock Exchange, President of the Association of Stock Exchange Firms, and, finally, President of the Securities Industry Association (40 A);

Dr. Beryl Robichaud—a Senior Vice President of McGraw Hill, Inc. She was also one of the first women officers of International Business Machines Corporation (40 A);

William J. Stephens—the retired Chairman of the Board and Chief Executive of Jones & Laughlin Steel Company. He was also a director of several major corporations (40 A);

* Under the Delaware Corporation Law (Section 141) and under the by-laws (Section 4, Article VI) and under the charter (Section 1, Article EIGHTH), one-third of the directors (i.e., four directors) constitutes a quorum—see Opinion of Judge Werker, 404 F. Supp. at 1175, fn. 1 (154 A).

Louis F. Laun—the Deputy Administrator of the Small Business Administration, Washington, D.C. He also had a long career in private industry prior to his government service (40 A);

Mary S. O'Connor—a director and member of the Executive and Trust Committees of the Central Home Trust Company of Elizabeth, New Jersey. She was also a former officer of International Business Machines Corporation (40 A).

To assist them in their consideration of the matter the five disinterested directors determined to retain independent special counsel (41 A). Pursuant to that decision, and after reviewing his background and qualifications, the five disinterested directors retained Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to review all relevant aspects of the matter and analyze the pertinent facts and relevant law and authorities (41 A).

On December 5, 1974, after several months of investigation, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum (41 A; 56 A-95 A).

Judge Fuld reported that he had reviewed the Complaint in the *Lasker* action and the relevant documents and depositions in the *Welch* action. He had also reviewed the files of Fundamental and Anchor relating to the purchase of the Penn Central commercial paper, and interviewed officers of Fundamental and Anchor who had knowledge of the relevant events (57 A). In addition, Judge Fuld reviewed the corporate documents of Fundamental, studied the applicable statutes and regulations, and conducted extensive legal research (57 A).

Judge Fuld advised the directors as follows in his December 5, 1974 memorandum:

"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper" (57 A).

Judge Fuld also identified and analyzed the alternative courses of action available to the directors (93 A-95 A), and concluded his memorandum as follows:

"It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

After receiving Judge Fuld's December 5, 1974 memorandum, the five disinterested directors carefully reviewed it and raised several questions regarding the subjects covered in the memorandum and the alternatives which were available to the directors of Fundamental (42 A).

In response to these questions raised by the five disinterested directors, on December 18, 1974, Judge Fuld prepared and delivered a brief supplemental memorandum. In his principal memorandum, Judge Fuld had advised the directors that, in his opinion, there was no violation of law by Anchor or by the directors of Fundamental (57 A). In his supplemental memorandum, he went on to add that, even if there were a possible claim, Fundamental did not necessarily have to prosecute that claim; he advised that whether or not a corporation seeks to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management, and is left to the discretion of the directors (42 A; 96 A-102 A).

After receiving Judge Fuld's supplemental memorandum of December 18, 1974, the five disinterested directors held

a series of special meetings devoted exclusively to this subject (42 A).

In their special meeting of December 18, 1974, the five disinterested directors met by themselves and reviewed the memorandum and the supplemental memorandum, discussed the questions each of them had with respect to the facts, the law and the alternatives available, and further determined the procedure they would follow in conducting their inquiry, including the subjects to be dealt with, the order in which they would deal with them, and whom they would question (43 A).*

Following this private discussion among themselves, the five disinterested directors invited various persons to join the special meeting for the purpose of responding to their questions—these persons included Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, who were, at the time of the events complained of, unaffiliated directors of Fundamental; and Eugene P. Souther, Esq., a member of Seward & Kissel, litigation counsel to Fundamental in the *Lasker* action (43 A).

The five disinterested directors asked Judge Fuld, among other things, for his opinion as to (a) the merits of each of the claims asserted in the *Lasker* action; (b) whether Anchor had followed proper procedure under the circumstances at the time in determining to purchase and retain the Penn Central commercial paper; (c) the standards the five disinterested directors should apply in determining what course of action to pursue; and (d) the alternatives available to the Board. Judge Fuld gave his opinion on these subjects, and emphasized that in making the decision the five disinterested directors should exercise their

* See also the minutes of the meeting of December 18, 1974 (103 A-116 A).

good faith business judgment as to what was in the best interests of the shareholders of Fundamental (44 A).

The five disinterested directors questioned Mr. Souther regarding the practical implications of each alternative outlined by Judge Fuld (44 A). They discussed the nature and extent of pre-trial discovery and trial preparation to be expected, the cost, and the business interruption that might be experienced by Anchor and how that might affect the interests of the shareholders of Fundamental (44 A). They also discussed the effect, if any, of the earlier decision of the Board of Directors to settle the case against Goldman, Sachs & Co., and the subsequent jury award to the remaining plaintiffs in the *Welch* action (44 A).

The five disinterested directors then interrogated Mr. Haire (44 A). They examined the decision to purchase the Penn Central commercial paper, the information available to Anchor at the time, the consideration Anchor gave before purchasing the commercial paper, the procedure Anchor followed in making the investment, the information available to the Board of Directors at the time with respect to that purchase and other purchases of commercial paper, the identity of other "sophisticated investors" who had purchased Penn Central commercial paper during the relevant period, the identity of those purchasers of such paper who held it at the time of the Penn Central reorganization, the anticipated effect on the shareholders of Fundamental if the *Lasker* action were to be prosecuted either under the control of Fundamental or under the control of the two shareholders who brought it, the anticipated effect on the investment adviser from the continued prosecution of the action and how that would affect Fundamental's shareholders, and the ability of Anchor to respond in damages should a judgment against it be obtained (44 A-45 A).

The five disinterested directors then excused Messrs. Phillips, Kemmerer and Haire and continued their discussions with Judge Fuld (45 A).

Having obtained from Judge Fuld the advice and information they sought, they then excused Judge Fuld and Mr. Souther, and continued to meet privately (45 A). During this second private portion of the meeting, they agreed that they wished to give further consideration to the matter and adopted a procedure for that consideration (45 A). Each of the five disinterested directors, if he or she had any additional questions, was to forward them to one of their number, Mr. Leon T. Kendall,* who was then designated to secure replies to these questions through Judge Fuld and Mr. Souther (45 A-46 A). The five disinterested directors also agreed not to have any contact with anyone affiliated with Anchor until they had reached their decision (46 A).

During late December 1974 and early January 1975, Mr. Kendall spoke by telephone with each of the other four disinterested directors, and gathered the questions they wanted answered (46 A). Indicative of the consideration the directors were giving to the matter is the letter written to each of his fellow directors by Mr. William J. Stephens on December 31, 1974, a copy of which is reproduced as Addendum A to this brief (121 A-124 A).

On January 3, 1975, Mr. Kendall reviewed the questions that he had gathered from the other disinterested directors with Judge Fuld in a conference call among Mr. Kendall, Judge Fuld and Mr. Souther (46 A). Mr. Kendall thereafter personally spoke with Judge Fuld by telephone without Mr. Souther (46 A).

* This procedure was adopted because the directors were widely scattered: Mr. Stephens lived in South Carolina; Mrs. O'Connor and Dr. Robichaud lived in different parts of New Jersey; Mr. Laun lived in Washington, D.C.; and Mr. Kendall lived in Wisconsin.

On January 6, 1975, another special meeting of the Board of Directors was held to review this subject, this time in New York City (46 A). Those present included four of the five disinterested directors: Mr. Kendall, Mr. Louis F. Laun, Dr. Beryl Robichaud, and Mr. William J. Stephens (46 A). Mrs. Mary O'Connor, the fifth disinterested director, was abroad on January 6, 1975, but she had spoken by telephone with Mr. Kendall several days earlier, and had communicated to him her views as to the action Fundamental should take (46 A-47 A). Mr. Souther was also present at this meeting at the request of the five disinterested directors to act as secretary of the meeting. No person affiliated with Anchor, and no person who was a defendant in the *Lasker* action was present at this special meeting of the Board of Directors (46 A-47 A).*

The five disinterested directors reviewed in detail each of the alternatives available to Fundamental (47 A). After several hours of deliberation, on the motion of Mr. Laun, seconded by Dr. Robichaud, the five disinterested directors (Mrs. O'Connor's vote being cast by Mr. Kendall in accordance with her prior instructions to him) voted to instruct counsel to move to dismiss the action as being contrary to the best interests of the shareholders of Fundamental (50 A).

Among the factors considered by the five disinterested directors in their decision, as set forth by Mr. Kendall in his affidavit in support of the motion to dismiss, were the following (47 A-49 A):

“(a) Chief Judge Fuld’s opinion that there is no merit to the action and little likelihood of its success;

* See also the minutes of the meeting of January 6, 1975 (125 A-131 A).

"(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

"(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from the efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

"(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

"(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash.

"(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

"(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

"(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analyzed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

"(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be liable to Fundamental; and

"(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

Litigation counsel for Fundamental, on the instructions of the five disinterested directors, thereafter moved to dismiss the *Lasker* action (33 A). Judge Werker, in a

comprehensive opinion, endorsed the basic theory of the motion, but denied the motion, with leave to renew following discovery by the plaintiffs on the issue of whether the directors were truly disinterested and independent (137 A-153 A). Judge Werker wrote (404 F. Supp. at 1180):

"If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board."

Thereafter, plaintiffs conducted the depositions of each and every one of the five disinterested directors, as well as the deposition of Mr. Haire, the Chairman of Anchor. In addition, plaintiffs requested and received extensive document productions (162 A; 214 A-1137 A).

The deposition transcripts, which were filed with Judge Werker and are reproduced in substantial part in the Appendix, demonstrate abundantly that the five directors were wholly disinterested and acted with complete independence of any and all defendants in the *Lasker* action* (214 A-1137 A).

Indeed, each of the five disinterested directors testified that neither he nor she had any contact whatsoever with Mr. Haire or anyone else from Anchor at any time during the period they were studying and deliberating this matter, nor had anyone from Anchor ever attempted to influence their deliberations in any way. See testimony of O'Connor (163 A; 167 A; 986 A-990 A); Rohichaud (163 A; 167 A; 904 A-909 A); Stephens (165 A; 167 A; 781 A-788 A); Laun (165 A; 167 A; 1129 A-1143 A); and Kendall (164 A;

* There is no claim in this case that the directors acted fraudulently or corruptly. See Opinion of Judge Werker, 404 F. Supp. at 1180 (152 A). See also the concession in Appellants' Brief, p. 59: "The issue here is independence, not bad faith."

167 A; 649 A-658 A). The testimony of Haire is to the same effect: "*I totally isolated myself from the whole proceeding*" (424 A) (emphasis supplied).

At the conclusion of the discovery proceedings, Fundamental, as per the leave granted in the original motion to dismiss, joined by all other defendants, renewed its motion to dismiss the *Lasker* action (160 A). Plaintiffs opposed the renewed motion to dismiss.

On January 7, 1977, the renewed motion to dismiss was granted in all respects (1150 A-1151 A). See Opinion of Judge Werker, 426 F. Supp. 844 (S.D.N.Y. 1977) (1138 A-1153 A). Judge Werker wrote (426 F. Supp. at 849) (1142 A):

"Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently" (emphasis supplied).

POINT I

The District Court correctly held that the decision to terminate this litigation was a matter for the business judgment of the directors, and that the directors were disinterested and independent.

A. *The decision to terminate litigation is a matter for the business judgment of the directors.*

Judge Werker correctly held (404 F. Supp. at 1179):

"... the decision whether or not to sue is a matter of internal management [citation omitted]. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue."

The courts have long recognized that the management of a corporation's affairs—including the decision whether or not to prosecute litigation—rests solely with the board of

directors, and absent fraud, corruption, or other invalidating factors, the board's decision is final. *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917); *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *Hawes v. Oakland*, 104 U.S. 450 (1882); *Ash v. IBM*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Swanson v. Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Bernstein v. Mediobanca Banca di Credito*, 69 F.R.D. 592 (S.D.N.Y. 1974).

In *Corbus*, *supra* (187 U.S. 455), the Supreme Court set forth the business judgment rule in the context of a litigation decision as follows:

"The directors represent all the stockholders, and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs." 187 U.S. at 463.

This doctrine was subsequently reaffirmed by the Supreme Court in *United Copper*, *supra* (244 U.S. 261). In

that case, the plaintiff shareholder claimed that his corporation had been damaged by the defendants' actions in violation of the antitrust laws. The board considered suing the defendants and refused to do so. The Supreme Court ruled that the shareholder could not then maintain the suit for the corporation. Justice Brandeis wrote:

"Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders." 244 U.S. at 263.

More recent cases have continued to adhere to this rule. In *Swanson, supra* (249 F.2d 854), the plaintiff shareholder claimed that his corporation had been defrauded in its purchase of certain properties. He asked the board to sue the alleged wrongdoers and the board refused. The Court of Appeals for the Seventh Circuit barred a derivative suit by the shareholder, holding:

"... if a board of directors, a majority of which are admittedly honest and have not been involved in the alleged wrongs, refuses a demand to bring suit, then the complaining shareholders' judgment shall not be substituted for that of the directors."

. . .

"A corporation's right not to sue is correlative to its right to sue. Unless an equitable basis for intervention be shown, an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board." 249 F.2d at 858, 859.

In *Ash v. IBM, supra* (353 F.2d 491), a shareholder of three publishing corporations asserted that IBM's acquisi-

tion of another publisher violated the antitrust laws to the damage to his corporations. He requested the boards of directors of his corporations to sue IBM under the antitrust laws, but the boards refused. The Court of Appeals for the Third Circuit affirmed the dismissal of a derivative suit by the shareholder, stating:

"The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring antitrust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. [citations omitted]. Prevailing doctrine in the state courts is to the same effect. [citation omitted]." 353 F.2d at 493.

As noted in *Ash*, the state courts also follow the rule that a valid business judgment of a corporation's board of directors—including whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit. E.g., *Findley v. Garrett*, 109 Cal. App. 2d 166, 240 P.2d 421 (Dist. Ct. App. 1952); *Ella M. Kelly & Wyndham, Inc. v. Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz v. Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963); *Beard v. Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-9 (1960); *Puma v. Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971); *Goodwin v. Castleton*, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944).

For example, in *Goodwin, supra* (19 Wash. 2d 748, 144 P.2d 725), minority shareholders had commenced a derivative action against certain members of the board of their

corporation, charging wrongful self-dealing and waste of corporate assets. After the suit had been pending for a few years, the then board of directors settled the corporate claim with the defendants. Noting that the board of directors had found, in its view, that there had been no wrongful conduct by defendants and that the suit had no merit (19 Wash. 2d at 757-58, 144 P.2d at 730), the Court dismissed the action, stating:

"Since those who conduct the affairs of the corporation or who have the ultimate power of control over it have the right, in the first instance, to determine whether a suit shall be brought by the corporation or whether an existing controversy shall be compromised without suit, so they also have the right to inquire, consider, and determine whether a suit already brought by a dissentient stockholder is well-founded, what its chances for success may be, and whether in any event its continued maintenance may injuriously affect the present or future prosperity of the corporation." 19 Wash. 2d at 764, 144 P.2d at 733.

The issue raised on this appeal has now also been addressed by three judges of the United States District Court for the Southern District of New York (Judge Werker in the case at bar, Judge Carter in *Gall v. Exxon*, *supra* (418 F. Supp. 508) and Judge Conner in *Bernstein v. Mediobanca*, *supra* (69 FRD 592)); all three have sustained the right of the directors, in the exercise of their business judgment, to forego or terminate litigation.

Judge Conner, in *Bernstein v. Mediobanca*, *supra*, relied on the rule as stated by the Court of Appeals for the Second Circuit in *Alleghany Corp. v. Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966). The Court there wrote:

"We know of no proposition of law that permits shareholders, absent any allegations of bad faith, collusion or negligence, concededly neither present nor charged

here, [citation omitted]—to intervene, as of right, in order to continue litigation that independent members of the Board of Directors, acting in good faith and in the exercise of sound business judgment have decided to terminate.” 344 F.2d at 573.

B. *The directors who made the decision to terminate this litigation were disinterested and independent.*

The record is clear that none of the five directors constituting the disinterested quorum had any personal interest in the outcome of the matter they were considering, and it is also clear that they acted with total independence of the defendants in the *Lasker* action. See citations to the testimony, *supra*, pp. 14-15.

Judge Werker, after permitting plaintiffs extensive discovery, found on this issue as follows (426 F. Supp. at 849) (1142 A):

“Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently” (emphasis supplied).

The principal arguments of plaintiffs on this issue were each considered and properly rejected by Judge Werker; they are found in Appellants’ Brief, Point VIII, pp. 59-69.

(1) the alleged “history of personal relationships”—

Plaintiffs seek to make much of the fact that each of the five directors was previously acquainted with someone on the Board of Fundamental—the short answer to this is that the members of the Board acted with common sense in nominating men and women whose work, character and careers were known first-hand to at least one member of the Board. Under the unrealistic procedure apparently suggested by plaintiffs, the members of the Board evidently were supposed to nominate persons whom

they did *not* know—this truly would have been an abdication of their duties as directors, and would have made no sense at all.

Furthermore, the nature, extent and importance of the personal relationships between the five directors and the defendants is much overstated by plaintiffs. None of the five directors who made the decision for the Board is related to any one of the defendants by blood or marriage; none had any personal stake in the outcome of their deliberations; none is or ever was a business partner of any of the defendants; none has or had any business or professional relationships with Anchor or any financial interest in Anchor; and none of them even had close personal friendships with any of the defendants—they were, at most, acquainted through community or business activities, and had casual social relationships. In short, none of the five had any disabling conflicts of interest which would have made it difficult or impossible to exercise his or her business judgment in the best interests of the stockholders of Fundamental.

The pertinent and undisputed facts about the relationships of the five disinterested directors with the defendants and with each other are these:

Leon T. Kendall—as of the time he became a director of Fundamental, in 1974, Kendall had no prior business or professional relationship with any of the defendants (649 A-655 A). Furthermore, as of the time he became a director of Fundamental, Kendall knew only two of the 11 individual defendants (Messrs. Haire and Burks) and one of the five directors who thereafter comprised the disinterested quorum (Mrs. O'Connor) (529 A; 531 A).^{*} As he testified, Mr. Kendall had never even met defendants

^{*} A chart setting out, in full, who knew whom, is reproduced in the Appendix (209 A-213 A).

Burr, Chalker, Hopkins, Hutchison, Kemmerer, Monroney, Phillips or Wade, nor had he met three of the four other directors who later served with him on the disinterested quorum—Messrs. Laun and Stephens and Dr. Robichaud—prior to becoming a director (533 A-534 A).

The sum total of Kendall's acquaintance with Mrs. O'Connor was based on the fact that she "lived in Elizabeth, or the same general area, and she either had a son or a nephew or grandson, or something, in school with my children, and we would see each other at the football or basketball, or whatever games" (530 A).

The sum total of Kendall's acquaintance with Dr. Burks was that he knew him from their mutual service on the School Board of Pingry School (531 A).

On the subject of his relationship with Mr. Haire, Mr. Kendall testified as follows (657 A):

"Q. Can you tell us once again, in your own words, the extent of your business relationship or professional relationship, if any, with Mr. Haire prior to the time that you became a director of Fundamental Investors? A. I had no business, professional, economic, financial relationships with Mr. Haire. The only relationship that existed was in the Trade Association, which I headed, and of which his company was a member."

On direct examination by plaintiffs, Mr. Kendall testified as follows regarding Mr. Haire (479 A-480 A):

"Q. Were you social friends? A. We were more business friends than social friends.

"Q. We'll get to what you were more of. The question, is, were you social friends? A. Would you define 'social friends'?

"Q. Doesn't that mean anything to you, 'social friends'?

* * * * *

"A. There are gradations in social friends. Has Mr. Haire ever had dinner at my house? No.

"Q. Do you consider him a social friend? A. I consider Mr. Haire a friend. I might, by my definition; I do not consider him a social friend. We do not play golf, tennis, play bridge, barbeque, socialize."

On cross-examination, Mr. Kendall elaborated on his relationship with Mr. Haire as follows (655 A-656 A):

"Q. Mr. Kendall, did you have any economic relationship with Mr. Haire in the sense that he ever paid you money personally or you ever paid him money personally for anything? A. No.

"Q. Were you ever his partner in any kind of a business transaction? A. No.

"Q. Did you ever engage in any investment of any kind with Mr. Haire? A. No.

"Q. Did Mr. Haire ever attempt to influence the deliberations of the disinterested quorum? A. No."

Dr. Beryl Robichaud—prior to becoming a director, she was not acquainted with *any* of the defendants. She knew none of the directors other than Mrs. O'Connor, who proposed her for the directorship (812 A).

The extent of Dr. Robichaud's prior relationship with Mrs. O'Connor, as Dr. Robichaud testified, was as follows (797 A-799 A):

"Q. Could you summarize for us generally the nature and extent of your relationship with Mrs. O'Connor from 1941, when you met her, to 1973, when she called you about becoming a director? A. The origin of my acquaintance with Mrs. O'Connor stemmed from the fact that we were both employees, women of the International Business Machines Corporation. We worked in different areas of responsibility and in different geographic areas. I met her there.

had not seen her thereafter for at least 10 or 15 years before she called me about the Anchor—the mutual fund directorship of the Anchor group.

* * * * *

“Q. Had you had any contact with her of any kind?

A. No.

“Q. During that period, no? A. No.

“Q. Would you describe for us the nature and extent of your relationship from 1941 to 1958 or 1963, whatever the date was that you last had contact with her prior to the phone call of 1973? A. During that period I would say that I probably saw Mrs. O'Connor no more than four or five times during that whole period of 20 years. Each occasion was a social event, and the common link were other people.

“Q. Were you social friends during that period?

A. No.

“Q. You saw each other at social occasions? A. Four or five times.

“Q. Did you have business contacts? A. No.”

William J. Stephens—the *only* defendant Mr. Stephens knew, at the time he became a director, was the late Harvey Hopkins (679 A). He was not acquainted with anyone at Anchor (678 A), and he did not know any of the four directors who later served with him on the disinterested quorum (679 A).

The nature and extent of Mr. Stephens' relationship with the late Harvey Hopkins (a non-affiliated director defendant who was, at most, a peripheral defendant in this lawsuit), was testified to by Mr. Stephens as follows (671 A-674 A):

“Q. Could you describe for me in your own words and as briefly as possible, the nature of your business relationship with Mr. Hopkins over those 30 years and whatever social relationship you might have had with him over those years?

* * * * *

"Q. Do you understand my question? A. I think so.

When I first knew Mr. Hopkins he was an executive in the research department of American Can Company. I was an executive with Bethlehem Steel. From time to time we would have conversations on matters in which I was interested in in being in the container business, he being interested in the steel business.

Later, and I cannot remember when, he left the American Can Company and went to ACF Industries. Mr. Hopkins, to the best of my recollection, retired in 1958 or thereabouts. After retirement he moved to the West Coast. Occasionally when he was in New York and we found our schedules were the same, we'd meet and have a talk about old times and that sort of thing.

"Q. Over the years that you knew him, prior to April, 1973, did you and Mr. Hopkins have social contacts. What I mean by that, did you ever visit him at his home or vice versa, that sort of thing? A. I visited him at his home and also played golf with him from time to time.

"Q. Did he reciprocate in the sense he visited with you in your home, that sort of thing? A. I can't recall that he did. We frequently would meet with our wives in New York and have dinner at night.

"Q. You say that was fairly frequently? A. Once or twice a year.

"Q. Did you ever, the two of you and your families, live in the same community or nearby communities? A. No, sir.

"Q. When you'd have occasion to visit each other's home or have dinner together and that sort of thing, where were you based and where was he based? A. I was based in Bethlehem, Pennsylvania. He was based in New York and lived in, some place in Westchester County, Chappaqua, I think was the name of the town he lived.

"Q. From time to time you might have occasion to come to New York and visit with him and he might have occasion to come to Pennsylvania?

* * * * *

"Q. Let me ask you the question:

Did he ever have occasion to come to Pennsylvania and meet with you either for lunch or for golf or—

A. Not that I recall.

"Q. So whatever contacts you had with him were on occasions when you or your wife may have had occasion to come to New York and you would visit with him.

A. Yes."

Stephens further testified, unequivocally, as follows (690 A):

"Q. Was your relationship with Mr. Hopkins in May of 1973 such over the 20 or some-odd years that you had known him that if you had at any time reached a conclusion on behalf of the fund that he should be sued, that you would do so only with substantial reluctance? A. I would do so without reluctance in the discharge of my duties as a director."

On the basis of the foregoing, it is clear that the nature and extent of his prior relationship with Hopkins did not disable Stephens either factually or legally from carrying out his functions as a director, and did not disqualify him from exercising his business judgment in this case.

Stephens further confirmed that, in becoming a director, he gave no thought whatsoever to the *Lasker* action (786 A):

"Q. Did the *Lasker* action play any part in your decision to become a director of Fundamental Investors? A. No, sir.

"Q. Did you ever discuss the *Lasker* action with Mr. Hopkins? A. I don't recall doing so."

Louis F. Laun—at the time he became a director of Fundamental, Laun knew none of the defendants except Dr. Phillips (1071 A-1072 A) and none of the directors who thereafter served with him on the disinterested quorum.

The extent of the relationship between Laun and Phillips was testified to by Laun as follows (1063 A-1065 A):

“Q. Mr. Laun, would you describe for us generally what the nature of the relationship has been between you and Mr. Phillips from, I believe you said 1948?
A. Yes.

* * * * *

I met Dr. Phillips in 1948, when I went to become assistant to the president of Bates Manufacturing Company, which was Maine's largest industry. My job was to be in charge of community and industrial relations for the company.

As such, I was thrown into a wide number of acquaintances throughout the state.

Dr. Phillips was president of Bates College at that point, and he also was working quite hard on town and gown things, the relationships between the University and the community. And so we would meet frequently at Chamber of Commerce meetings, at Community Chest meetings, at YMCA meetings, at Lewison Development meetings, and that sort of thing.

I left Maine in 1955 to go to New York, I don't think I saw him for about ten years or so in the interim.

I was doing some work with the Sperry and Hutchinson [sic] board and our acquaintance got renewed when he came down to the Sperry Hutchinson Board meeting, and we saw each other, I'd say, oh, gosh, that's fourteen or fifteen years now that I think of it, after the time I had seen him.

During this period I had dinner with him once, and then after, of course, I got on the Anchor group of mutual fund's board, I've been seeing him once a month.”

Mary S. O'Connor—at the time she became a director, she was not acquainted with any of the defendants other than Messrs. Haire and Burks (937 A) nor anyone at Anchor (937 A).

Mrs. O'Connor testified as follows with respect to the nature and extent of her relationship with Dr. Burks (919 A-920 A):

"Q. How long had you know [sic] Dr. Burks? Was it Dr. Burks, by the way? A. Yes.

"Q. As of the time you had this conversation with Mr. Haire. A. I cannot recollect how many years.

"Q. Many years? A. Since I've been in Elizabeth.

"Q. How long had you been in Elizabeth, approximately, as of— A. Forty years."

* * * * *

"Q. Did you consider Dr. Burks a close friend of yours at this time? A. No.

* * * * *

"Q. How would you characterize, how would you describe whatever relationship existed between you and Dr. Burks as of the time we're talking about? A. A casual friendship among people in the community."

Mrs. O'Connor testified as follows with respect to the nature and extent of her relationship with Mr. Haire (916 A-917 A):

"Q. Could you approximate how long you'd known Mr. Haire? A. Not over ten years."

* * * * *

"Q. Does Mr. Haire or anyone related to Anchor serve on the Central Home Trust Company of Elizabeth board? A. No."

On cross-examination, Mrs. O'Connor testified, unequivocally, that she was neither influenced nor pressured, in any way, by Mr. Haire or anyone else from Anchor Corporation in her deliberations as a member of the disinterested quorum (989 A-990 A).

In sum, as Judge Werker correctly held, casual relationships of the kind these people had with one another or with the defendants do not provide any basis whatsoever for stripping them of their power to exercise their business judgment as members of the Board of Directors.

Plaintiffs also argue (Appellants' Brief, Point VIII, pp. 64-66) that the members of the disinterested quorum could not have been independent since the persons who nominated them for their positions on the Board were defendants in the *Lasker* action. This argument is without merit. Plaintiffs conducted extensive discovery on the issue of independence, but were unable to adduce any evidence whatsoever that any member of the disinterested quorum was influenced in any way by any defendant in the *Lasker* action. The testimony clearly shows that no defendant ever mentioned the *Lasker* action to any one of the five directors prior to, at the time of, or in connection with, his or her nomination to the Board, and that the first time that these five directors focused on the *Lasker* action was at the July 24, 1974 meeting when they were designated as a quorum to decide what position should be taken by Fundamental (527 A-529 A; 688 A; 704 A; 786 A; 854 A-855 A; 943 A-948 A; 990 A).*

(2) the alleged "substantial remuneration" received by the directors—

In the 1,000-plus pages of deposition testimony, there is not one shred of evidence that any of the five directors was influenced, in any way, by the receipt of directors' fees or the prospect that if he or she voted a particular way on

* One of the five disinterested directors, Mr. Laun, became a director in 1971 (1042 A) before there even was a *Lasker* action—this further shows the implausibility of plaintiffs' theory that these five directors were nominated to the Board for the purpose of disposing of the *Lasker* action.

this issue, that he or she might not be renominated as a director and might thereby lose future directors' fees. Plaintiffs have not cited and cannot cite any testimony or any document in support of this hypothesis. In advancing this argument, plaintiffs ask this Court to draw an unwarranted inference against the integrity of the five directors, and one which is contrary to the evidence before this Court. The deposition testimony shows that the five directors took their duties very seriously and exercised their business judgment without regard to considerations of personal gain to themselves or favor to the defendants. Judge Werker so found (426 F. Supp. at 852) (1149 A-1150 A).

Furthermore, in view of the reputations, achievements and high standing of the five directors, it would be both unrealistic and unfair to draw any inference against them to the effect that their actions were influenced by the directors' fees they received.* Most directors of most corporations receive directors' fees, and it would be erroneous to say that because they do, they are disqualified from exercising their business judgment.

(3) the plaintiffs' legal authorities on the issue—

The cases cited by plaintiffs in support of their arguments in Appellants' Brief, Point VIII, pp. 66-67 are

* In *Warshaw v. Calhoun*, 43 Del. Ch. 148, 221 A.2d 487 (1966), a business judgment case in the Supreme Court of Delaware, Chief Justice Wolcott disposed of the salary argument as follows:

"The plaintiff suggests that the salaries paid them [the directors] by Casualty were their real motive, and that they had no real interest in the welfare of Securities. The point, however, is little more than a suggestion and is not developed. We think the mere statement of fact of salary payments by Casualty to some of the Securities directors does not, in itself, overcome the presumption of good faith accorded to the acts of directors." 43 Del. Ch. at 158, 221 A.2d at 493.

merely generalized statements, having no particular bearing on the issue at bar.

Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968), *reh. denied*, 393 U.S. 1112 (1969) involved the alleged bias of an arbitrator. To attempt to equate the role of the five disinterested directors to that of an arbitrator or a judge misconceives their function. The five disinterested directors were not arbitrators or judges, and never sought to act as such. Their function was to make a good faith exercise of business judgment in the best interests of Fundamental, based upon all relevant business, legal and practical considerations.

Similarly, the citations to or quotes by plaintiffs from Fletcher's, from *City Bank Farmers Trust Co. v. Cannon*, 291 N.Y. 125 (1943), from *York v. Guaranty Trust Co.*, 143 F.2d 503 (2d Cir. 1944), *rev'd* 326 U.S. 99 (1945) and from *Bayer v. Beran*, 49 N.Y.S.2d 2 (Sup. Ct., N.Y. Co. 1944)—all of which merely recite the black letter proposition that trustee fiduciaries cannot serve where they have conflicts of interest—are not in point. Plaintiffs have not shown and cannot show that any of the five directors had any such conflict of interest.

Ripley v. Int'l Rys. of Central America, 8 A.D.2d 310 (1st Dep't 1959), *aff'd* 8 N.Y.2d 430 (1960), involved the control and domination exercised by a parent over a partially owned subsidiary. At bar, no such fact situation is involved and no such control or domination has been shown by plaintiffs. The Court in *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963), a derivative action by a mutual fund stockholder, correctly held that evidence of a casual acquaintance or friendship between board members is "shallow and inconsequential" on the issue of control or domination, and does not warrant "any

sinister or diabolical implications" regarding the director's independence of his fellow board members.

(4) the burden of proof on the issue—

Plaintiffs also argue, in Point VIII, that the defendants "should have the burden of proof" on the issue of independence (Appellants' Brief, p. 68).^{*} This argument was also expressly considered and rejected by Judge Werker in his Opinion.

Judge Werker wrote (426 F. Supp. at 852) (1148 A-1150 A):

"Finally, the plaintiffs contend that under *Pertman v. Feldman*, 219 F.2d 173, 178 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), and *Pepper v. Litton*, 308 U.S. 295, 306 (1939), the defendant directors bear the burden of proving by clear and convincing evidence that they did not breach their fiduciary responsibilities to the corporation and its stockholders. The defendants argue that the plaintiff must shoulder the evidentiary burden because it is the exercise of business judgment by corporate directors which is challenged. *Bellis v. Thal*, 373 F. Supp. 120, 124 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975); *Marco v. Bank of New York*, 272 F. Supp. 636, 639 (S.D.N.Y. 1967), *aff'd*, 398 F.2d 628 (2d Cir. 1968); *Warshaw v. Calhoun*, *supra*.

"The *Pertman* and *Pepper* cases relied upon by the plaintiffs both involve self-dealing by corporate fiduciaries and are inapplicable here. As I noted in my earlier decision in this matter, the plaintiffs 'have not argued that the minority directors have acted fraudulently or corruptly.' 404 F. Supp. at 1180. Moreover, the question before the court is not whether the defendants breached their fiduciary obligations to the cor-

^{*} The question as to who has the burden of proof on the issue of independence is of little consequence, since Judge Werker held that even if defendants do have the burden of proof they satisfied it (426 F. Supp. at 852) (1149 A).

poration, but whether suit can proceed against them at all given the decision of the nondefendant minority directors to seek dismissal of this action.

"It is therefore incumbent upon the plaintiffs to establish that the minority directors actions lacked independence. *Marco v. Bank of New York, supra*. The unsupported contentions of the plaintiffs clearly fail to meet this burden and, accordingly, it is the opinion of this court that the defendants, both corporate and individual, cannot be required to proceed to a trial. *I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so.* The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit" (emphasis supplied).

(5) plaintiffs' other miscellaneous points—

Plaintiffs also argue, in Point VII, that Mr. Haire "misled" the disinterested directors, and that Eugene P. Souther, Esq., litigation counsel to Fundamental, was not "disinterested" within the applicable statutory definition and that this somehow infects the independence of the five directors (Appellants' Brief, pp. 52-59). These arguments are unfounded and were expressly considered and rejected by Judge Werker in his Opinion.

As to the point about Mr. Haire, Judge Werker wrote (426 F. Supp. at 851-852) (1147 A-1148 A):

"... plaintiffs point to the allegedly misleading nature of statements made to the minority directors by defendant Haire. The minutes of the first special meeting of the disinterested quorum state that Haire 'questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if [the instant action] were being pursued with the acquiescence, if not under the control, of the Fund.' The plaintiffs consider this to be in sharp disagreement with Haire's testimony at his deposition that he 'never at any time had any doubt that [Anchor] could continue to effectively serve the [F]und if . . . requested to continue or permitted to continue by the board or the shareholders.' Apparently to underscore the materiality of Haire's discouraging words to the minority directors, plaintiffs note the contents of an affidavit by the chairman of the disinterested quorum. In that affidavit, the quorum chairman states that in reaching their decision the directors considered that:

"(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders . . ."

"The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows

only that the minority directors reached a different conclusion: that prosecution of the suit 'would necessarily cause the Fund to seek to obtain a different investment adviser immediately.' Even if the minority directors erred in this determination, as I have noted in my previous decision, the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence."

As to the point about Mr. Souther, Judge Werker wrote (426 F. Supp. at 850-51) (1146 A-1147 A):

"It is the court's opinion that the role of Souther was equally innocent. The plaintiffs advance two reasons why it was inappropriate for him to participate as he did in the deliberations of the disinterested quorum. First, they note that he was an 'interested person' within the meaning of §2 of the Investment Company Act, 15 U.S.C. §80a-2(a)(19)(A)(iv) because his law firm had acted as legal counsel to the Fund during the last two fiscal years. They question whether the minority directors could arrive at a disinterested decision when they were advised by an attorney who was 'interested.' Second, the plaintiffs contend that it was improper for his firm to counsel parties with divergent interests, namely the Fund and the disinterested quorum.

"All attorneys providing legal counsel to mutual funds become, by definition, 'interested persons' for some period of time. Under §10 of the Investment Company Act, 15 U.S.C. §80a-10, only 60 percent of the members of the board of a registered company may be interested persons. Designating Souther as an interested person, therefore, only serves to limit his participation on the Board *as a director*. It does not mean that the minority directors were interested in the suit, that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence.

"Plaintiffs nevertheless suggest that in accordance with Judge Frankel's recent decision in *Papilsky v. Berndt*, [[1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627 (S.D.N.Y. 1976)], it was improper for Souther to advise both the Fund and the minority directors. However, in *Papilsky*, the law firm advising the fund also served as the investment adviser's counsel, and, as Judge Frankel noted, there was no 'suggestion to the Board that, because of the possible conflict of interest, the independent directors should seek disinterested counsel.' *Id.* at 90,133. In the instant action, independent legal advice for the minority directors was not only recommended, it was also obtained. Moreover, there was no conflict of interest on the part of Souther or his law firm: they were retained to represent the Fund in the instant action and it was the disinterested quorum, acting for the Fund, which gave them their instructions as to how to proceed."

POINT II

Plaintiffs' arguments are without merit.

Substantially every argument raised by plaintiffs on this appeal was raised before Judge Werker in the District Court. The arguments are insupportable on the facts and on the law.

A(1). The policy argument.

Plaintiffs first argue (Appellants' Brief, Point I, pp. 8-12) that the result below is "inconsistent with the strong policy considerations" which have necessitated that a private right of action be implied under Section 36 of the Investment Company Act and Section 206 of the Investment Advisers Act—plaintiffs are in error.

Judge Werker fully considered and properly rejected this point (404 F. Supp. at 1179-80):

"This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike §16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Acts. It is true that causes of action under those Acts are implied rights of action. [citations omitted]. It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

If Congress had wanted or intended to create a statutory exception in the Investment Company Act and/or in the Investment Advisers Act to preclude exercise of business judgment by directors, it could and would have done so. No such exception exists or should be implied.*

* In *Santa Fe Industries, Inc. v. Green*, — U.S. —, 45 U.S. L.W. 4317, 4322 (March 23, 1977), the Supreme Court recently underscored the primacy of state law on questions relating to the power of directors, quoting from its earlier decision in *Cort v. Ash*, 422 U.S. 78, 84 (1975):

"Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation" (emphasis supplied by Supreme Court).

The Court of Appeals for the Second Circuit clearly recognized the viability of the business judgment rule in the context of mutual funds in *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, — U.S. —, 97 S. Ct. 77 (Oct. 4, 1976). Judge Friendly, writing for the Court, pointed the way to a proper exercise of business judgment by independent directors of a mutual fund and, in doing so, described precisely the steps which, in fact, were taken by the directors at bar (533 F.2d at 749-50):

“Congress had mandated independent directors in order ‘to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.’ [citation omitted]. The minimum requirement to enable the Fund’s independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

“If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case.”

At bar, the independent directors made a careful investigation of the matter with the aid of disinterested counsel—*precisely* the course of action described as the appropriate course of action by Judge Friendly in *Fogel v. Chestnutt*, *supra* (533 F.2d at 749-50).

A(2). The Section 17(h) argument.

Plaintiffs next argue (Appellants' Brief, Point I, pp. 12-18) that the result below "violates both the letter and spirit of Section 17(h) of the Investment Company Act" * —plaintiffs are in error.

Section 17(h) provides that neither the charter, nor the by-laws of a mutual fund shall "contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders . . ." Neither the charter nor the by-laws of Fundamental contains any such provision.

In support of their argument, plaintiffs point to the quorum provisions of the Fundamental charter and by-laws as provisions which allegedly protect or exonerate the directors from liability for gross misconduct and abuse of trust. This borders on the absurd. The quorum provisions are the normal, straightforward provisions found in the by-laws and/or charters of virtually every corporation of any kind, and they do not exculpate anyone from any liability. The motion to dismiss was not premised, as plaintiffs argue (Appellants' Brief, p. 13), on the quorum provisions, but on the business judgment rule.

Chabot v. Empire Trust Co., 301 F.2d 458 (2d Cir. 1962), cited by plaintiffs (Appellants' Brief, pp. 14-15) is not in point. In *Chabot*, there was an express provision in a trust agreement requiring shareholders to post a bond to indemnify the trustee for costs and expenses in actions brought by shareholders against the trustee. The plaintiffs there had to post \$35,000 in security in order to maintain their action. The Court held that this clause had the practical effect of shielding the trustee from liability by preventing lawsuits. The quorum provisions of the Funda-

* Plaintiffs did not raise this point in the District Court and, arguably, they are barred from raising it on appeal for the first time. *Hormel v. Helvering*, 312 U.S. 552, 556 (1941).

mental charter and by-laws had no such effect; they merely determined the number of directors necessary to transact business.

Section 17(h) has no applicability whatsoever to this appeal.

B. The ratification argument.

Plaintiffs next argue (Appellants' Brief, Point II, pp. 18-22) that the directors' exercise of business judgment to end this suit constituted an improper "ratification" of non-ratifiable illegal conduct—plaintiffs are in error. The directors did not ratify anything. The directors decided only that it was not in the best interests of Fundamental's shareholders to have this action continue.

Judge Werker fully considered and properly rejected this point below (404 F. Supp. at 1180):

"The court must also reject plaintiffs' argument that the decision not to sue was tantamount to an illegal ratification . . . [T]he question of business judgment is separate from the question of ratification [citations omitted]. Many of the cases which established the business judgment rule and its relation to derivative suits have involved claims which were arguably non-ratifiable." [citations omitted].

Other courts have also so held. *Gall v. Exxon Corp.*, 418 F. Supp. 508, 518 n.18 (S.D.N.Y. 1976); *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*, 326 Mass. 99, 111, 93 N.E. 2d 241, 247 (1950); *Kessler & Co. v. Ensley Co.*, 129 F. 397, 399 (CC N.D. Ala. 1904).

Thus, in *Solomont*, *supra* (93 N.E. 2d 241), the Court stated:

"The question whether it is good judgment to sue is quite apart from the question of ratification."

.

"We know of no principle requiring that a corporation once wronged cannot exercise an honest judgment to refrain from doing that which may wrong it even more." 326 Mass. at 111, 115, 93 N.E. 2d at 247, 249.

And in *Kessler, supra* (129 F. 397), the Court said that a refusal to sue did not constitute ratification:

"There is a manifest distinction in principle between . . . piling one fraud on another by abuse of corporate authority in vicious ratification, and the refusal by the governing body, on proper motives, of a request of some of the stockholders to bring suit to redress the fraud. Of and in itself the mere refusal to sue cannot be ratification." 129 F. at 399.

And in *Gall, supra* (418 F. Supp. 508), the Court endorsed Judge Werker's analysis, and wrote:

" . . . the decision by the Special Committee not to sue does not constitute the ratification of an illegal act. The question of the good faith exercise of sound business judgment is entirely separate from the question of ratification. See *Lasker v. Burks, supra*, 404 F. Supp. 1172, at p. 1180." 418 F. Supp. at 518 n.18.

In support of their argument, plaintiffs advance two points.

First, plaintiffs argue that the *Solomont* case has no applicability here because it is "a demand case." (Appellants' Brief, p. 21). This is wrong. *Solomont* is not a demand case; it is a business judgment case (326 Mass. at 100, 93 N.E. 2d at 241).^{*} But even if *Solomont* had been a demand case, that would not vitiate the Court's holding, and supporting reasoning, that a decision not to sue does not equal ratification (326 Mass. at 111, 93 N.E. 2d at 247).

^{*} Indeed, *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964)—upon which plaintiffs place heavy reliance—expressly distinguished *Solomont* from demand cases on the ground that *Solomont* was not a demand case. 334 F.2d at 818.

Levitt, supra (334 F.2d 815), cited by plaintiffs, is not in point. In that case, which involved the special Massachusetts shareholder demand rule, the question before the Court was whether a demand upon *shareholders* is necessary prior to commencement of a derivative action under the Investment Company Act. *Levitt* did not deal with the question of whether *directors* can, in any event, exercise their business judgment to terminate a derivative action. Subsequent to *Levitt*, the Court of Appeals for the First Circuit expressly reaffirmed the responsibility and power of directors to control litigation in actions under the Investment Company Act, by holding that a demand on directors in such actions is required—even though a demand on shareholders is legally excused. *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 266-67 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). *Mayer v. Adams*, 37 Del. Ch. 298, 144 A.2d 458 (Del. 1958), also cited by plaintiffs, is not in point in that it, too, deals with the question of demand on shareholders, not demand on directors or business judgment.

Second, plaintiffs argue that the cases which Judge Werker relied upon allegedly involved merely “a routine business decision” and did not involve any issue of “sanctioning non-ratifiable conduct” such as fraud (Appellants’ Brief, pp. 21-22). This argument, however, overlooks the numerous other cases where the courts have upheld the power of disinterested directors not to pursue litigation, even though arguably non-ratifiable conduct was at issue. See, e.g., *Alleghany Corp. v. Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966) (involving fraud claims); *Swanson v. Traer*, 249 F.2d 854, 856 (7th Cir. 1957) (involving fraudulent conspiracy); *Goodwin v. Castleton*, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944) (involving fraud claims); *Brody v. Chemical*

Bank, 517 F.2d 932 (2d Cir. 1975) (involving federal securities acts and fraud claims); *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976) (involving illegal payments).

Plaintiffs also attempt to distinguish these cases on the ground that they involved decisions to sue third parties rather than fiduciary insiders, such as directors, for fraud or misconduct. Plaintiffs overlook the fact that many of these cases cited above did involve claims against fiduciary insiders for alleged fraud or misconduct.

For example, in *Swanson v. Traer*, 249 F.2d 854 (7th Cir. 1957), the charge was that certain former directors had fraudulently sold property they owned to the corporation at inflated prices, and that other directors, in collusion with them or otherwise, were guilty of fraud or waste (see prior decision, 230 F.2d 228 (7th Cir. 1956)). The Court correctly upheld a subsequent Board's decision not to sue:

"... it may be the exercise of the highest wisdom that the corporation not file a suit as demanded by the plaintiffs and, further, that [the new] directors were better able to act understandingly on the subject than the plaintiff stockholders..." (249 F.2d at 857).

C. *The Section 36(b) argument.*

Plaintiffs next argue (Appellants' Brief, Point III, pp. 22-27) that the disinterested directors cannot have final decision-making authority without permitting shareholders to have judicial review of their decisions; they place principal reliance for this argument on Section 36(b) of the Investment Company Act, a provision not involved in the *Lasker* action, and on *Boyko v. The Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1975)—plaintiffs are in error.*

*None of the other sections cited by plaintiffs (i.e., Sections 15(c), 16(b), 17(b) or 32(a)) provides for a mechanism of judicial review and, accordingly, they are not relevant to the point raised by plaintiffs.

Judge Werker considered and properly rejected the same argument raised by plaintiffs on a motion for reargument in the District Court (158 A-159 A).

As Judge Werker held, neither Section 36(b) of the Investment Company Act nor *Boyko* has any applicability at bar. *Boyko* and Section 36(b) involve compensation of investment advisers—*Lasker* does not.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act—it is a unique and highly specific section dealing solely with the issue of compensation of investment advisers. Section 36(b) expressly creates a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to compensation. Section 36(b)(2) expressly authorizes the court, in such an action, to give such consideration “as is deemed appropriate” to the approval by the directors or ratification by the stockholders of such compensation.

If Congress had wanted to amend Section 36(a) (or any other section of the Investment Company Act) to extend the unique mechanisms of Section 36(b) to other sections, it could and would have done so—it did not do so. The general rule was and still is that the responsibility for managing the affairs of a mutual fund rests with the directors, not with the judiciary. Any other result would strip the directors of their power and responsibility, and enmesh the judiciary in the multi-faceted complex daily affairs of all mutual funds.

Judge Werker correctly held that Section 36(b) represents a specific *exception* legislated by Congress to the general rule that final authority rests with the directors. The compensation of investment advisers (like insider profits under Section 16(b) of the Exchange Act) is a peculiarly sensitive issue and one on which Congress saw

fit to legislate a specific exception to the normal governing rule, i.e. that the decisions of the directors, in the absence of bad faith or fraud, are conclusive. There is no evidence whatsoever that Congress intended to or did extend the special provisions of Section 36(b) to business judgments of directors on issues other than compensation.

No claim is (or could be) made in *Lasker* under Section 36(b) and, accordingly, *Boyko* which deals only with Section 36(b) is inapposite.

D. The Rule 23.1 argument.

Plaintiffs next argue (Appellants' Brief, Point IV, pp. 27-31) that once the requirements of Rule 23.1, Fed.R.Civ.P., the demand rule, have been satisfied, directors cannot exercise their business judgment to terminate litigation—plaintiffs are in error.

First, plaintiffs have not cited any judicial or statutory precedent whatsoever for this novel argument.

Second, there is authority for the contrary proposition, i.e., that directors may, at various stages,* exercise their business judgment to terminate litigation. See e.g. *Alleghany Corp. v. Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966); *Goodwin v. Castleton*, 19 Wash. 2d 748, 144 P.2d 725 (1944).

As the Court stated in *Goodwin*, *supra*:

"Since those who conduct the affairs of the corporation or who have the ultimate power of control over it have the right, in the first instance, to determine whether a suit shall be brought by the corporation or whether an existing controversy shall be compromised without suit,

* At bar, the disinterested directors exercised their business judgment to terminate this litigation at the earliest possible stage, i.e., prior to the joinder of issue—accordingly, the "parade of horrors" conjured up by plaintiffs regarding intervention of directors late in the litigation process (Appellants' Brief, p. 30) has no applicability to this case.

so they also have the right to inquire, consider, and determine whether a suit already brought by a dissident stockholder is well-founded, what its chances for success may be, and whether in any event its continued maintenance may injuriously affect the present or future prosperity of the corporation." 19 Wash. 2d at 764, 144 P.2d at 733 (emphasis supplied).

See also *Brody v. Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975) for the proposition that, as circumstances change, newly elected directors may pass anew on pending litigation—any other rule would freeze the board into the situation existing at the outset of suit, without being able to consider subsequent facts.

The mere fact that demand on directors may be legally excused does not prevent directors from exercising their business judgment to terminate litigation validly commenced by a stockholder suing derivatively—the demand rule simply sets down the mechanism for getting into court. If the directors choose to ignore the matter, the stockholder suing derivatively can remain in court on behalf of the corporation; however, where the directors properly and validly exercise their business judgment, it is they—not the stockholder suing derivatively—who have the power to determine the corporation's course of conduct in litigation. This point was recognized in the very case relied on by plaintiffs. *Nelson v. Pacific Southwest Airlines*, 399 F. Supp. 1025, 1031 (S.D. Cal. 1975).

E. The demand cases argument.

Plaintiffs next argue (Appellants' Brief, Point V, pp. 31-34) that all cases relied on by defendants are "demand" cases; this case is not a "demand" case, *ergo*: all cases relied on by defendants are inapplicable—plaintiffs are in error.

First, not all of the cases relied on by defendant are demand cases: e.g. *Goodwin*, *Alleghany* and *Gall* all involved decisions of directors to terminate litigation, and none of them involved the issue of demand.

Second, the mere fact that the business judgment cases relied on by defendants arose, for the most part, in fact situations in which there was also an issue of demand on directors does not mean that 70 years of federal and state court precedent on the business judgment rule are suddenly of no value. The issues of demand on directors and exercise of business judgment by directors are separate and distinct, and address themselves to different points.

As noted above in our brief at p. 45, plaintiffs have not cited a single case which holds that the demand rule, once satisfied by a stockholder suing derivatively, strips the directors of their power and responsibility to exercise their business judgment in relation to the derivative litigation.

In the cases relied on by plaintiffs (*Nelson v. Pacific Southwest Airlines*, 399 F. Supp. 1025 (S.D. Cal. 1975); *Papilsky v. Berndt*, 503 F.2d 554 (2d Cir.), cert. denied, 519 U.S. 1048 (1974) and *Baffino v. Bradford*, 57 F.R.D. 79 (D. Minn. 1972)) the board either ignored a demand or a demand was legally excused—however, in none of those cases did the Board actually exercise its business judgment.

At bar, where a disinterested quorum, acting for the corporation, has exercised its business judgment, and not simply remained inert, the business judgment rule, not the demand rule is the governing principle. In such circumstances, as demonstrated above in our brief at pp. 15-20, the courts have uniformly recognized that the judgment of directors not to prosecute litigation will not be overturned barring fraud or collusion—neither of which is present or even claimed to be present at bar.

F. *The merits argument.*

Plaintiffs finally argue (Appellants' Brief, Point VI, pp. 34-52) that the Court should consider the merits of their underlying claims since the merits are "compelling"—this would render the business judgment rule meaningless. Under the business judgment rule, as it relates to decisions involving litigation, the merits of the underlying claims are only one factor to be considered by the directors. Unless the view taken of the merits by the directors is patently absurd such as to cast doubt on the good faith of the directors—which clearly is not the case here—the courts will not substitute their judgment for the business judgment of the directors. See cases cited *supra*, pp. 15-20.

At bar, the disinterested directors in their investigation carefully and fully considered the merits of plaintiffs' claim in the *Lasker* action, as well as numerous other factors (see e.g. 39 A-50 A; 121 A-124 A).*

Chief Judge Fuld studied and reported in detail to the disinterested directors on the merits of each and every claim raised by plaintiffs in the *Lasker* action. Among his findings on the various claims asserted by plaintiffs in the *Lasker* action were the following:

"It is my opinion that neither Anchor nor any Fund director is liable to the Fund under Section 36 of the

* Plaintiffs also argue that Rule 23.1, Fed.R.Civ.P., requires discovery on and a judicial review of the merits of the underlying claims—this argument misconceives the application of Rule 23.1 Fed.R.Civ.P. and would eviscerate the business judgment rule. Under Rule 23.1, Fed.R.Civ.P., *voluntary* dismissals require notice to stockholders and court approval after a hearing—that rule does not govern *involuntary* dismissals as at bar, where there is no risk of a collusive settlement. *Wolf v. Barkes*, 348 F.2d 994, 995-97 (2d Cir. 1965), *cert. denied*, 382 U.S. 941 (1965); *Marcus v. Textile Banking Co.*, 38 F.R.D. 185, 187 (S.D.N.Y. 1965) (Tenney, J.). See also: Simeone, *Procedural Problems of Class Suits*, 60 Mich. L.Rev. 905, 934 (1961-62); Miller, *Problems of Giving Notice in Class Actions*, 58 F.R.D. 313, 331 (1973).

Investment Company Act of 1940 for the Penn Central loss" (67 A).

—and—

"In my opinion, the element of fraudulent intent is necessary to establish a private cause of action under Section 206. Consequently, since for the reasons stated in my discussion of Section 36, there is a total absence of any such intent, it follows that there is no liability under Section 206 on the part of Anchor or the Fund directors" (73 A-74 A).

Chief Judge Fuld also extensively discussed and analyzed plaintiffs' theories of common law and contractual liability (74 A-91 A); and he concluded that Anchor had not breached any duty or any contractual liability to Fundamental. As previously noted, Chief Judge Fuld wrote:

"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper" (157 A).

Also, as Judge Werker noted, the merits were merely one of many factors considered by the directors in exercising their business judgment. Thus, Judge Werker wrote (404 F. Supp. at 1180) (152 A):

"Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, *there were many other factors considered by the directors*—as outlined in the Kendall affidavit ¶22*—which led the directors to their decision" (emphasis supplied).

Finally, there is no question that the exercise of business judgment made by the directors in this case was made in good faith and was eminently reasonable—Judge Werker

* 47 A-49 A.

expressed it well in his second Opinion when he wrote (426 F.Supp. at 852) (1149 A-1150 A):

"The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit."

CONCLUSION

The judgment of the Court below dismissing this action should be affirmed.

Respectfully submitted,

SEWARD & KISSEL

*Attorneys for Fundamental
Investors, Inc.*

POLLACK & KAMINSKY

*Attorneys for Anchor Corporation,
Edward B. Burr, Thomas F.
Chalker, John R. Haire and
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Harvey C. Hopkins, Donald L.
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Charles L. Phillips and Jephtha
H. Wade*

ADDENDUM A

a

WILLIAM J. STEPHENS
21 LIVE OAK ROAD
HILTON HEAD ISLAND, SOUTH CAROLINA 29928

December 31, 1974

Re: The Derivative Action
Lasker et al
February 1973

Dear Leon,

At this date I wish to advise that my tentative conclusion is that, in the best overall interest of Fundamental Investors, Inc., this derivative action should not be prosecuted and should therefore be dismissed.

I have given consideration to the following:

#1 - Judge Stanley H. Fuld's statement contained in his letter of December 5, 1974 which reads - "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

#2 - There is no hard evidence that the adviser did not exercise due care and diligence in the Penn Central transaction. The certain guidelines established for the purchase of commercial paper from dealers are evidence that this transaction was not entered into lightly. It is reasonable to conclude the guidelines were truly a sufficient safeguard.

#3 - It is also reasonable for the adviser to place reliance on the presentation and recommendation of Goldman, Sachs & Co., a most astute, prestigious and highly regarded investment banker.

#4 - As a purchaser, Anchor was in "first class" company and this conclusion was arrived at by an examination of the "Investor Sales Analysis" from 3/1/68 to 4/2/70, a 12 page document prepared by Goldman, Sachs & Co. Also examined was the list of 73 banks that bought and/or sold Penn Central paper, mostly for the account of customers. It seems evident that the investment community highly regarded the Penn Central commercial paper and purchased it as late as 4/2/70. The statement showed sales of \$172,505,000 in this period, not including the \$20,000,000 purchased by Anchor. The amount not paid at maturity was \$52,205,000 including the \$20,000,000 Anchor buy.

#5 - Commercial Paper was fully accepted by the investment community. The outstanding commercial paper in the first part of 1970 exceeded \$40 billion.

(continued)

b

WILLIAM J. STEPHENS
21 LIVE OAK ROAD
HILTON HEAD ISLAND, SOUTH CAROLINA 29928

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#6 - In August 1968 the Interstate Commerce Commission gave Penn Central authority to sell \$35 million in commercial paper. On December 17, 1968 the I. C. C. increased the authorization to \$100 million. On May 18, 1969 Penn Central announced an increase to \$150 million, approved by the I. C. C. On October 29, 1969 the I. C. C. agreed to permit the sale of up to \$200 million. At this time the comment on the decision by the I. C. C. to increase to \$200 million was, "On the whole, applicant is in a strong financial condition."

#7 - Penn Central had a \$50 million revolving credit plan. In April 1969, with First National City as the lead bank, the amount of the revolving credit was increased to \$300 million. All \$300 million was used by the railroad, which eventually defaulted on the loan. There were about ninety banks involved; the majors were First National City \$35 million, Irving Trust and Morgan Guaranty \$25 million each, Manufacturers Hanover \$20 million, with Bankers Trust of New York, Chemical Bank New York Trust, First National Bank of Chicago and Continental Illinois Bank at \$15 million each. It is clear the banks did not contemplate that the railroad would be bankrupt within 14 months!

#8 - Of more than passing interest is the interlocks of Penn Central directors with the major banks of Penn Central and the railroads indebtedness to these banks as of May 12, 1970.

<u>Director</u>	<u>Bank</u>	<u>Amount</u>
S. Saunders	Chase Manhattan	\$7,832,500
	First Pennsylvania	18,004,766
D. Beran	Provident National	57,074,895
P. Gorman	Bankers Trust	26,063,106
J. T. Dorrance, Jr.	Morgan Guaranty	90,972,957
A. E. Perlman	Marine Midland	1,083,651
R. S. Rauch, Jr.	Girard Trust	49,408,188
R. G. Rincliffe	Philadelphia National	12,480,000
	Total	\$262,920,063

On June 8, 1970 International Utilities was the largest shareholder of Penn Central with 500,000 shares. They were in the midst of taking a loss of \$8 million on their holdings. John Seabrook was Chairman of International Utilities and a Director of Penn Central.

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Also it is to be noted that the total railroad indebtedness to First National City was more than \$300 million. They were not represented on the Board of Penn Central.

My only comment on this is the observation that the Directors did not know or understand the "soft under belly" of the railroad until it was too late. Question? - If the Directors did not grasp the real financial posture of Penn Central, was it possible for Anchor to reach behind the scenes and get the true picture?

#9 - On merger day February 1, 1968 Penn Central had assets of \$6.5/7.0 billion. In just 871 days later, on June 21, 1970, bankruptcy proceedings were filed under Section 77. Penn Central was regarded as the backbone of the country's transportation system and had a "Rock of Gibraltar" stature. "Nothing can happen to Penn Central" was accepted in financial centers across the nation. "The banks are behind Penn Central," was regarded as Gospel.

#10 - In part, my conclusion that the Lasker derivative action should not be prosecuted stems from my concern about the possible impact on Anchor and Fundamental Investors, Inc.

First, as to Anchor:

The amount involved exceeds the total assets of Anchor and, if the award was made, Anchor would cease to be a viable organization. Their ability to attract and retain skilled fund managers would be gone. It would indicate that the Fund Board believed Anchor had violated the law and breached their contractual obligations to the Fund. I do not so believe. It would be inconsistent to retain Anchor as the Fund adviser and join in a suit against them at the same time. Would the Fund flounder in the interim of changing advisers? I fear so.

Second, as to the Fund:

The impact on the Fund, as a result of public knowledge that the Board had become a plaintiff in prosecuting Anchor would probably result in heavy redemptions. This would compel distress selling of the Portfolio in the current depressed market. As of November 30, 1974, Total Net Assets were \$531 million, Short Term investments \$21 million, Cash and Receivables \$15 million. Net Asset Value per share was \$5.13. Recovery of the total amount

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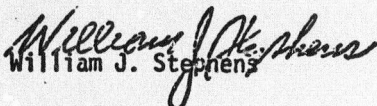
represents about \$.13 a share which is 2½%. The Net Asset Value of the shares, I believe, would be damaged by a far greater percentage if the Board supported the suit. I do not make light of the sum involved but wanted to put it into perspective.

#11 - It is my tentative business judgment that the Lasker suit is without merit and that it would not prevail.

SUMMARY

These are my thoughts at this time. I will await answers to some questions that other Directors and I have asked before coming to a final conclusion.

Respectfully submitted


William J. Stephens

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